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SOUTH CAROLINA GENERAL ASSEMBLY

Legislative Audit Council

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A REVIEW OF THE DEPARTMENT OF INSURANCE

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Synopsis

Members of the General Assembly requested the Legislative Audit Council to conduct an audit of the South Carolina Department of Insurance (DOI). Our audit focused on four main areas:

- Workers' Compensation Insurance
- Coastal Property Insurance
- Overall Regulation of Insurance
- Captive Insurance

While we found that DOI generally regulates the insurance industry appropriately, we found many areas where improvement is needed to ensure that the department, the insurance industry, and the public are aware of possible problems and issues. Our findings are summarized below.

Workers' Compensation Insurance

We reviewed how DOI regulates workers' compensation insurance by examining rate filings and overall industry data. We also looked at how other states regulate workers' compensation insurance to recommend possible changes in state law.

- Overall, 73 (97%) of 75 of the rate filings reviewed had missing information. This information included financial data, actuarial reviews, and approvals. Forty-one filings (55%) were exempt from prior approval based on the deregulation in South Carolina law between 2003 and 2007.
- Without a summary document or checklist in each filing, as well as the appropriate information from insurers, it is difficult to determine if the appropriate analysis or any analysis was conducted by the department.
- Insurance companies are allowed to use any year's loss cost data when calculating rates. In order to prevent the possibility of companies' manipulating rates and to be consistent with other states, state law should be amended to require insurers to use the most recently approved loss cost data when calculating rates.

Coastal Property Insurance

We reviewed how DOI regulates coastal property insurance and if that regulation is in compliance with state law and insurance industry standards. We also reviewed how the South Carolina Wind and Hail Underwriting Association (SCWHUA) operates. The regulation of coastal property insurance was also examined to determine if any changes could be made to improve the regulation in South Carolina.

- Nine (25%) of 36 filings reviewed had no evidence of DOI's review or an explanation of its decision. Completing checklists that DOI already has and including them in the file would show that the department is evaluating all aspects of the filings and how it reached its decision.
- As required by state law, SCWHUA should include procedures in its plan of operation for procurement of reinsurance. These procedures should include better use of evaluation criteria to make the process more open and objective.
- The department should continue its efforts to evaluate hurricane models for South Carolina to ensure that the rates charged by insurers are appropriate.

Overall Regulation of Insurance

We reviewed how the department regulated other types of insurance such as life, health, and automobile insurance. We looked at how DOI ensures the financial solvency of insurance companies and reviews rate increase requests.

- We reviewed rate change requests submitted to DOI to determine whether adequate procedures were in place for analyzing the requests in order to make appropriate decisions for approval or denial. We generally found adequate support for the decisions. By failing to document all aspects of a rate change request, the department's decisions may not be adequately explained or supported.
- We reviewed the operations of the financial analysis division to determine if the department ensures that insurance companies comply with South Carolina law and National Association of Insurance Commissioners' (NAIC) guidelines. We found that the files contained adequate documentation to establish that desk audits had been conducted in accordance with South Carolina laws and NAIC regulations. However, none of the samples indicated that the risk-based capital ratio had been reconciled between the company's annual statement and the NAIC calculations.
- Our examinations of the DOI schedule of audits confirmed that examinations were scheduled and completed in accordance with state law.

Captive Insurance

We reviewed DOI's regulation of captive insurance companies which are a risk-financing method or form of self-insurance involving the formation of companies to serve the insurance needs of parent companies or their members. We found that generally the department's licensing and examinations of captives complies with state law and regulations. We did find the following problems with DOI's regulation of captives.

- We found that the department did not collect all of the required information from companies. Without this information, the department may not be able to adequately determine if the company will be able to remain financially solvent and protect its parent company or members.
- The department did not have standard procedures for conducting the financial examinations of captives which are not risk retention groups. These examinations are required by state law. The agency has now developed standard procedures and, according to an agency official, implemented them in December 2008.
- We reviewed DOI's schedule of examination dates for captives and found that 43 (81%) of 53 reviews had not been completed within the three-year period required by state law. By not having procedures as discussed above and failing to complete examinations as required by law, the department cannot adequately ensure that the captive insurance companies are able to meet their financial obligations.

Introduction and Background

Audit Objectives

Members of the General Assembly requested the Legislative Audit Council to conduct an audit of the South Carolina Department of Insurance (DOI). The requesters had four main areas of concern:

- Workers' compensation insurance rates.
- Coastal property insurance rates and availability.
- Overall regulation of insurance.
- Captive insurance.

Our objectives were to determine how the department regulates workers' compensation insurance, coastal property insurance, and the insurance industry, and if that regulation is in compliance with the law and insurance industry standards. As part of the coastal property insurance review, we also examined the operations of the South Carolina Wind and Hail Underwriting Association (SCWHUA).

Scope and Methodology

We reviewed the operations of the department including its rate approval process and the licensing and examination of insurance companies. We did not review how DOI licenses insurance agents, handles complaints concerning insurance companies and agents, or administers its operations. We also reviewed the operations of SCWHUA. The period of review was generally FY 05-06 and FY 06-07, with consideration of earlier and more recent periods when relevant.

To conduct the audit, we used evidence which included the following:

- DOI records of licensing, rate requests, financial analyses, and examinations.
- Federal and state laws and regulations.
- Interviews with DOI employees, employees of other states' insurance departments, and other interested parties.
- DOI financial records, policies, and bulletins.
- Information and accreditation reviews from the National Association of Insurance Commissioners (NAIC).
- Records from the S.C. Wind and Hail Underwriting Association.

Criteria used to measure performance included state laws and regulations, agency policy, the practice of other states, and insurance industry standards. We used several nonstatistical samples, the results of which cannot be applied to the whole population. These samples are described in the audit report. We reviewed internal controls in several areas including licensing, ratemaking, and financial analyses and examinations. Our findings are detailed in the report.

When addressing our audit objectives, we used information from several of DOI's information systems. We could not audit or verify all of the information obtained from these systems, and we concluded that it may be unreliable. However, we analyzed the information we received and compared it with other sources and known evidence. We concluded that the evidence obtained was adequate to support the findings, conclusions, and recommendations in the report. We conducted this audit in accordance with generally accepted government auditing standards.

Background

The South Carolina Department of Insurance (DOI) is a state agency which is managed by a director who is appointed by the Governor with the advice and consent of the Senate. The director is responsible for supervising and regulating the financial solvency and market practices of insurers in South Carolina and ensuring that all state laws governing or relating to the business of insurance are executed.

The mission of the department is to be responsible for ensuring the solvency of insurers, protecting consumers by administering and enforcing insurance laws, and regulating the insurance industry in an efficient, responsive, and equitable manner.

The department is divided into four strategic areas.

GENERAL COUNSEL AND FINANCIAL SERVICES DIVISION oversees all legal services, insurer licensing, and financial solvency matters.

DIVISION OF CONSUMER SERVICES AND AGENTS LICENSING is primarily focused on education and licensing of insurance producers, brokers, service contract providers, third-party administrators, bail bondsmen, utilization review agents, premium service companies, and insurance-related organizations' affiliates as required by law. The division also handles consumer complaints.

DIVISION OF ADMINISTRATION AND GRANTS SERVICES directs human resources for approximately 100 full-time employees and manages the agency's central file records. The division also provides public information and administers mitigation grants to strengthen homes against the severe winds associated with hurricanes and natural disasters.

DIVISION OF ACTUARIAL, MARKET AND ALTERNATIVE RISK TRANSFER SERVICES handles the rates, rules, and forms submitted by insurance companies and analyzes their market conduct. The division manages the captive insurance industry and other alternative risk transfer mechanisms in the state and provides, manages, and outsources actuarial duties that are required by the department.

DOI regulates all types of insurance sold in South Carolina, such as life insurance and annuities, accident and health, property, casualty, surety, marine, and title unless exempted from regulation by state law. Insurance companies are required to pay license fees and annual premium taxes. License fees are also required for insurance producers and brokers, bail bondsmen, adjusters, damage appraisers, administrators of insurance benefit plans, service contract providers, and reinsurance intermediary brokers.

The department collects approximately $175 million each year in taxes and fees from the insurance industry. As required by statute, more than 95% of that revenue is transferred to the general fund. Less than 5% is earmarked or restricted for DOI use. The General Assembly then appropriates funding for the agency, which amounts to less than 7% of the revenue that was collected (see p. 4). Table 1.1 shows revenues collected and expenditures for FY 05-06, FY 06-07, and FY 07-08.

Table 1.1: South Carolina Department of Insurance Revenues and Expenditures

	FY 05-06 (% of Total)	FY 06-07 (% of Total)	FY 07-08 (% of Total)
Revenues*			
Transferred to General Fund	$147,151,799 (97%)	$177,121,742 (95%)	$168,903,074 (96%)
Earmarked	2,920,913 (2%)	7,535,270 (4%)	5,217,195 (3%)
Restricted	1,883,757 (1%)	1,817,663 (1%)	1,750,251 (1%)
TOTAL	**$151,956,469**	**$186,474,675**	**$175,870,520**
Expenditures**			
General Fund	$3,599,909 (41%)	$4,287,999 (43%)	$5,329,893 (40%)
Earmarked	3,408,224 (39%)	3,922,841 (39%)	6,191,561 (47%)
Restricted	1,750,936 (20%)	1,838,983 (18%)	1,708,038 (13%)
TOTAL	**$8,759,069**	**$10,049,823**	**$13,229,492**

* Examples of **general revenues** collected include broker premium taxes, workers' comp insurance tax, insurance premium tax, insurance license fees, and others. Examples of **earmarked** funds collected are examining fees and travel reimbursement, agent license fees, captive insurance company fees and assessments, and other miscellaneous revenue. Examples of **restricted** funds collected are uninsured motorist fund administration of investment earnings and miscellaneous transfers.

** Examples of **general and earmarked expenditures** include staffing and benefits, utilities, data processing equipment, and general operating expenses. Examples of **restricted** expenditures include office and postage supplies and expenses allocated to the private sector.

Source: DOI and Office of Comptroller General

The department is regulated by state law and is a member of the National Association of Insurance Commissioners (NAIC). The NAIC is an organization of insurance regulators from the 50 states, the District of Columbia, and 4 U.S. territories that provides a forum for the development of uniform policy among insurance departments. The NAIC also functions as a repository for insurance data for the states. Similar information is assembled from all insurance companies and is made available to all state departments of insurance. The financial data assembled by the NAIC is used by state departments of insurance in the analysis of insurer financial statements and examinations.

NAIC accreditation reviews are conducted every five years, with more frequent interim reviews. Each year, the department submits an interim report concerning its compliance with NAIC accreditation standards. According to the *DOI Agency Accountability Report for Fiscal Year 2006-2007*, accreditation indicates to other insurance departments, existing and potential licensees, and other department stakeholders that DOI maintains qualified staff, has appropriate insurance company solvency monitoring safeguards in place, conducts financial examinations and financial analysis in compliance with NAIC's guidelines, and has enacted the necessary statutes and regulations to adequately govern South Carolina's insurance industry.

The department successfully completed its five-year accreditation review by NAIC in 2006. Its next accreditation visit is scheduled for Spring 2011.

Audit Results

Workers' Compensation Insurance

We reviewed how the South Carolina Department of Insurance (DOI) regulates workers' compensation insurance by examining rate filings and overall industry data. We found that 97% of the rate filings reviewed had missing information including financial data, actuarial review, and approval details. However, the department reports that 41 (55%) of these filings were between June 2003 and June 2007 and thus, exempt from filing submission and prior approval. We also found that state law does not require insurance companies to use the most recently approved loss cost data when calculating rates.

Workers' compensation insurance is required by state law for most employers and provides benefits if an employee suffers job-related injury, disease, or death, regardless of fault. The S.C. Workers' Compensation Commission is responsible for the promulgation of all regulations relating to administration of workers' compensation laws in South Carolina. DOI is responsible for approving rates and classifications for all workers' compensation insurers.

Premiums are the amounts that employers pay to purchase workers' compensation insurance. The premiums charged by insurance companies are based on loss costs determined by the National Council on Compensation Insurance (NCCI). These loss costs must be approved by DOI. Insurance companies use these approved loss costs and add additional expenses to determine their premiums, the amount they will charge.

South Carolina Code §38-73-510 requires workers' compensation insurers to be a member of a rating organization. NCCI is the only licensed advisory rating organization in South Carolina. It is a nonprofit organization which deals with workers' compensation data, statistics, and research. NCCI collects statistical and financial information concerning workers' compensation exposure and claims from insurers in 39 states, including South Carolina.

For workers' compensation, the term "losses" means medical benefits paid to or for the benefit of persons injured in workplace accidents, and lost wages and other compensation paid for those accidents. Loss costs include these costs and the costs of adjudicating the claims. NCCI periodically reviews the overall level of loss costs as well as the allocation of these costs to each classification. Among other things, NCCI's review includes the assessment of historical experience reported by insurers, trend analysis, and the effects of law changes or other changes on prospective costs.

Based on its assessment of the adequacy of approved loss costs, NCCI files proposed changes in the loss costs with DOI. The department must approve or disapprove the NCCI request.

The approved loss costs do not make up the entire manual rate because they do not include the costs for several types of expenses incurred by companies. Each insurance company considers its individual expenses, including acquisition costs, general expenses, taxes, license fees, loss prevention activities, Second Injury Fund assessments, and profit. The rates are determined by applying a factor to the approved loss costs to incorporate these expenses and any adjustments to the approved loss costs. If the department does not approve the loss cost filing, NCCI has the right to appeal the case to the Administrative Law Court. NCCI filings in 2005 and 2007 requested loss cost increases of 32.9% and 23.7%, respectively. DOI disputed the proposed rates of increase which resulted in increases of 18.4% and 9.8%, respectively.

Prior to 2003, DOI approval was required for workers' compensation insurers' loss cost multipliers and rates. Following the approval of S.C. Reg. 69-64 in June 2003, DOI approval was no longer required for insurers' loss cost multipliers (LCM) and manual rates. Insurers were required to prepare their LCM filings as if they had to submit them to the department, but submission was not required. Insurers were required to maintain desk file copies of their filings and to submit their filings to the department for review upon request. In 2006, the department issued a data call to all insurers writing workers' compensation for information related to their LCM filings.

In June 2007, the General Assembly passed legislation that reformed workers' compensation. Among the changes made to the workers' compensation law under Act No. 111 were the requirements of filing of loss costs and loss cost multipliers by insurance companies and the termination of the Second Injury Fund. This law again made the South Carolina Department of Insurance responsible for approving loss cost multipliers and manual classification rates.

Rate Regulation

Loss costs are the costs that the insurance companies may or may not adopt as a basis for the rates they charge. Insurance companies may either adopt the approved loss costs or maintain their current rates, which are based on previously approved loss costs.

The loss cost multiplier (LCM) is developed by the insurer and, from June 2003 through June 2007, it was exempt from filing submission and prior approval. It takes into account underwriting expenses — the costs the company must incur to do business (NOT the costs associated with specific claims, but the overhead costs). The LCM may also include an adjustment for experience that differs from the overall state experience. Since 2000, South Carolina has seen an increase in the average loss cost multiplier and also in rates. The LCM has increased over 30% from 2000 to 2006, as shown in Table 2.1.

Table 2.1: Increase in Average Loss Cost Multiplier 2000 – 2006

JULY 1	LCM IN EFFECT	ANNUAL PERCENT CHANGE IN LCM IN EFFECT
2000	1.390	
2001	1.440	3.6%
2002	1.640	13.9%
2003	1.670	1.8%
2004	1.690	1.2%
2005	1.740	3.0%
2006	1.830	5.2%

Source: South Carolina Department of Insurance

In addition to increases in the LCM, we also identified increases in other areas. When we examined the average expense rates from 2000–2005, there was a 14% increase from 2000 to 2005. Additionally, the percentage of the average expense rate attributed to the Second Injury Fund almost doubled between 2000 and 2005. The profit component of the expense rate more than doubled during this same time period.

Although insurance rates nationally have been increasing, rates in South Carolina have shown a higher-than-average increase. A survey by the Oregon Department of Consumer and Business Services suggested that in 1998 South Carolina had the lowest workers' compensation rates in the country. By 2006, South Carolina's rates ranked 25th nationally and in 2008, South Carolina ranked 12th. In the 11-year period between 1998 and 2008, the workers' compensation rates in South Carolina have gone from the lowest in the country to some of the highest.

We reviewed workers' compensation filings submitted to DOI to determine what information was required for submission by DOI and whether adequate procedures were in place for analyzing the requests.

DOI was unable to provide an exhaustive list of all workers' compensation filings between 2000 and 2007. The department did provide a listing of 48 filings that it had readily available. This listing became our intended sample of workers' compensation filings. The files presented during the review were not completely representative of those on the list initially presented by DOI, however, each of the files provided was reviewed.

We reviewed 75 filings, 41 of which were exempt from approval by the department because of deregulation between 2003 and 2007. The other 34 filings required prior approval by the department. For each filing, we noted the following information — whether an actuary reviewed the filing, whether there were Second Injury Fund assessments accounted for, whether any financial exhibits or information were provided in the file, the effective date of the requested change, and the date of the approval/disapproval of the request by the department.

- **An actuarial review of filing** — When reviewing filings, the department has an actuary review the file and make a recommendation whether or not the filing should be approved. The department indicated to us that it did not actively practice this policy while commercial insurance lines were deregulated. In 5 (7%) of the 75 filings reviewed, an actuarial review and opinion was present.

- **Second Injury Fund assessments accounted for —** In their filings, carriers are asked to indicate the amount they paid in SIF assessments. Insurance carriers must contribute to the Second Injury Fund. In 66 (88%) of the 75 filings reviewed, Second Injury Fund assessments were indicated.

- **Financial exhibits and information provided in file —** The department indicated to us that it does not approve rate or loss cost changes unless it has adequate reason to do so. Carriers are required to provide financial documentation that the change is necessary. In 46 (61%) of the 75 filings reviewed, financial exhibits and other information were included. Forty-one files reviewed (55%) were exempt filings.

- **Effective date of requested change —** In filings, carriers should indicate the specific date in which they want their requested change to take effect. In 69 (92%) of the 75 filings reviewed, the effective date of the requested change was indicated. In other situations, the department reports that filings take effect upon approval.

- **The date of the approval/disapproval of the request by the department —** In our review, we found that DOI used a stamp to indicate the date which the filing had been approved. However, only 29 (39%) of 75 filings we reviewed were stamped with the date the file was approved by the department. None of the filings we reviewed had stamps indicating disapproval by the department. According to the department, this does not mean that all filings were approved. A number of the filings were closed by the department due to a lack of information or because they were withdrawn by the insurer.

With some files, the department clearly stamped with the date when the filing was received and when it was approved. However, for other files, this was not the case. There was no other indication, other than the stamp, if the file was actually approved. There were many files that had no stamps and it was unclear if these files were reviewed at all. In their procedural binder, DOI provided us with a checklist that it used to review all filings. However, there was no evidence of this, or any, checklist within any of the files reviewed, nor were there any notations regarding who specifically reviewed the file or when it was reviewed.

An official at the department mentioned that the department will not allow companies to change rates or loss costs unless they have adequate reason to do so. They are required to provide financial documentation that the change is necessary. However, during our review, we found multiple filings where there was no financial information provided and the filings were approved. We also did not find any filings that had been stamped as disapproved.

Overall, 73 (97%) of the 75 files reviewed had some missing information component. Table 2.2 details this missing information in the workers' compensation filings we reviewed. The table includes all filings reviewed, both exempt and ones requiring prior approval. Forty-one filings (55%) were exempt from prior approval based on the deregulation in South Carolina law between 2003 and 2007.

Without a summary document or checklist in every filing, as well as the appropriate information from insurers, it was difficult to determine if the appropriate analysis or any analysis was conducted by the department. From June 2003 through June 2007, the department did not regulate rates and loss cost multipliers of insurers providing workers' compensation coverage. Therefore, for some of the files reviewed, DOI reported that no analysis was required, as these filings were exempt from review.

Table 2.2: Percentage of Missing Documentation in Workers' Compensation Filings

Documentation	Missing	Present
Actuarial Review	70 (93%)	5 (7%)
Second Injury Fund	9 (12%)	66 (88%)
Financial Exhibits	29 (39%)	46 (61%)
Approval Date / Status	46 (61%)	29 (39%)
Effective Date of Change	6 (8%)	69 (92%)

Source: DOI Workers' Compensation Filings 2000–2007

Loss Costs

Another area of regulation of workers' compensation insurance may be improved. State law does not require insurers to use the most recent loss cost data in calculating their rates. An NCCI official was unaware of any other state that did not require companies to adopt the current year's loss cost. A DOI official expressed concern that some companies may use older loss costs in order to manipulate rates.

Recommendations

1. The Department of Insurance should require insurers to provide all necessary information on workers' compensation filings and should retain copies of this information.

2. The Department of Insurance should maintain copies of checklists, actuarial memos, and communications of decisions regarding workers' compensation filings.

3. The Department of Insurance should document evidence that decisions for workers' compensation filings have been reviewed and approved.

4. The General Assembly should amend Title 38, Chapter 73 by adding a section requiring all workers' compensation insurers to use the most recently approved loss cost data when determining rates.

Coastal Property Insurance

We reviewed how the Department of Insurance (DOI) regulates coastal property insurance and whether that regulation is in compliance with state law and insurance industry standards. We also reviewed how the South Carolina Wind and Hail Underwriting Association (SCWHUA) operates. The regulation of coastal property insurance was also examined to determine if any changes could be made to improve the regulation in South Carolina. We found that DOI has made efforts to ensure that rates charged for coastal property insurance are not excessive, inadequate, or unfairly discriminatory, but the department needs to better document its review process. SCWHUA should improve its process for selecting a reinsurance broker. The department should also continue its plans to develop a hurricane model to ensure more accurate rates.

Background

Coastal property insurance is both commercial and residential property insurance written along South Carolina's coast. S.C. Code §38-75-310 defines the coastal area in South Carolina for commercial and residential insurance products. After Hurricanes Katrina and Rita hit the Gulf Coast in August and September 2005, insurance companies had losses that were estimated to be greater than $45 billion. In several coastal states, including South Carolina, this resulted in significant increases in many coastal property owners' insurance premiums, and the canceling of many other coastal property owners' policies.

In South Carolina, over 32,000 personal coastal property insurance policies were cancelled from January 2006 through September 2008, according to DOI's SCWHUA Status Report for 2008. Some of the policies appear to be shifting from including wind coverage to excluding wind coverage.

- The total number of new and renewal policies written with wind coverage has decreased from 83,000 in January 2006 to almost 73,500 as of September 2008, a decrease of 11%.
- The total number of new and renewal policies written without wind coverage has increased from 67,000 in January 2006 to almost 88,500 in September 2008, an increase of 32%.

In 2007, the Omnibus Coastal Property Insurance Reform Act became law. This law included measures intended to increase the availability of coastal property insurance and to ensure that the rates are appropriate.

Regulation

S.C. Code §38-73-430(4) requires that the department regulate rates so that they are not excessive, inadequate, or unfairly discriminatory. We reviewed a nonstatistical sample of 36 filings from 2006, 2007, and 2008 to determine how DOI evaluated coastal property insurance filings. For the filings, we reviewed the company's request, documentation of DOI's actions, and the final decision on the filing. We found the following.

- Nine (25%) of 36 filings had no evidence of DOI's review or an explanation of its decision.
- For two files, DOI did not clearly indicate in the file what decision had been made.
- Twenty-eight (78%) of the 36 filings were submitted electronically while 8 were submitted on paper. The electronic filings generally included more evidence of DOI's actions than the paper filings.
- DOI required further information from companies that requested rate increases when the department was not convinced that the increased rates should be approved.
- DOI also required companies to lower the percentage of some requested rate increases before they would be approved.
- DOI denied rate increases when they would have been excessive or inappropriate.

Although the files included evidence that the department had reviewed the filings, there was often no evidence in the files of what the department reviewed to evaluate the filings or how the decisions were made.

The department should better document what it has reviewed and how it reached a decision on a filing. DOI has checklists for use in evaluating filings. DOI should follow the checklists when reviewing filings to ensure that insurers have complied with all applicable regulations, that all rate increase requests are appropriate and justified, etc. The completed checklist in each reviewed filing would serve as documentation that DOI completed all required steps for completing each review.

DOI has improved its documentation of the process it uses to review filings in the past few years by using NAIC's electronic system SERFF (System for Electronic Rate and Form Filing). SERFF allows insurance companies to file online with DOI, and allows DOI to keep all relevant paperwork online in the system. With paper filings, DOI often was missing important information that would have documented the process, such as objection letters to a company from DOI. With SERFF, these items are present in the file and there is a more complete record of the process DOI used to review the filing. DOI should continue to encourage companies to use electronic filing, and take advantage of systems that would improve record retention and documentation as they become available.

South Carolina Wind Pool

The South Carolina Wind and Hail Underwriting Association (SCWHUA or Wind Pool) was established by statute in 1971. The Wind Pool provides wind and hail coverage for residential and commercial property in the defined coastal area, when applicants are otherwise unable to get insurance coverage. SCWHUA consists of all private insurers who write property insurance in South Carolina on a statewide basis. These insurers are required to participate in funding the plan and share in any profits or losses. The Wind Pool is considered an insurer of last resort; it provides a temporary source of insurance until the applicant can obtain coverage through another insurer.

The number of policies written by the Wind Pool has increased since 2006. As of December 15, 2008, there were 45,387 policies written with premiums totaling almost $98 million. The number of personal policies written increased by 18% from 2007 to 2008 while the number of commercial policies decreased by 34%.

The policies issued by SCWHUA provide over $17 billion in coverage. In order to cover all of these policies, the Wind Pool uses reinsurance which is obtained from many different international markets. S.C. Code §38-75-340(A)(10) requires that SCWHUA operate in accordance with a plan of operation which includes "procedures for an open, competitive process for the acceptance and cession of reinsurance." The Wind Pool's current plan of operation does not include the procedures required by state law.

SCWHUA conducted a competitive process to select a reinsurance broker from September 2007 to February 2008. We reviewed the process and found the following.

- The Reinsurance Committee of SCWHUA had begun the process to select a reinsurance broker in 2004. Due to instability in the reinsurance market after Hurricane Katrina in 2005, the committee decided to postpone the process for three years.
- Due to the expiration of the commitment with the current broker in 2008 and the improvements in the reinsurance market, the committee issued a Request for Proposals (RFP) in November 2007.
- The committee heard presentations from eight firms in January 2008 and selected three firms for a second presentation.

- These three firms made presentations to the committee in February 2008 and the current broker was awarded the contract.

While S.C. Code §38-75-340(A)(10) states that SCWHUA is not required to follow the provisions of the South Carolina Procurement Code, we found that the Wind Pool could use the procurement code as guidance to ensure that the RFP process is more open and competitive. We found the following areas where the process could be improved.

- The relative importance of the evaluation factors should be stated in the RFP.
- These factors should be included on the committee members' evaluation forms for their use when evaluating the proposals.
- Price should be included as a factor to ensure that cost-effectiveness is part of the criteria for selecting a broker.

By making the process more open and objective, SCWHUA could better assure that it is selecting the broker that would be most advantageous for its program.

The rates charged by SCWHUA must be approved by DOI. The Wind Pool uses hurricane modeling to develop its rates. We reviewed the 2006 and 2007 SCWHUA rate filings submitted to DOI. We found the following during our review.

- The 2006 filing resulted in a 4.3% overall rate change. There was evidence in the file of an actuarial review and correspondence from SCWHUA. There was no evidence in the file of DOI staff review other than an approved stamp. The filing appears to have been handled by the DOI director.
- The 2007 filing resulted in a 35% overall premium increase. There was evidence in the file of DOI staff review of the request. There was no evidence in the file of an actuarial review or of DOI's approval of the rate filing.

In order to ensure consistent review of SCWHUA filings, DOI should document its review of the filings with the same documentation recommended for all coastal property insurance filings (see p. 14).

Changes to Coastal Property Insurance Regulation

In 2007, the South Carolina General Assembly passed the Omnibus Coastal Property Insurance Reform Act. This act expanded the coastal area covered by the Wind Pool, created tax credits to make insurance more affordable for homeowners, and created tax credits and grants for improvements to coastal homes that would protect against hurricane damage. For example, the S.C. Safe Home grant award program was created within the department, which provides grant money to homeowners who make wind resistance improvements to their homes that would prevent future hurricane damage to the structure. In FY 07-08, 522 awards of up to $5,000 each were issued for improved wind resistance. The act also requires that DOI review the Wind Pool rate structure every six months for adequacy.

DOI has not developed or approved a hurricane model specifically for South Carolina insurers to use when determining coastal property insurance rates. Instead, it approves hurricane models for use in South Carolina. Commercial vendors create catastrophe models each year based on historical storm data and other information. These models are used to predict the likelihood, frequency, and severity of future hurricanes for different coastal regions. Insurers rely heavily on these models to determine where they will provide coastal property insurance, how much coverage they will provide, and how much they will charge for that insurance. In 2005, the department created a three-member panel to review hurricane models. While three models were filed with the department, no model was ever approved for use as a South Carolina-specific model.

DOI has monitored Florida's hurricane model in recent years to determine which aspects can be incorporated in hurricane models approved for use in reviewing rate filings in South Carolina. Florida's hurricane model process is established by statute and includes a panel of experts which approves models to be used by Florida's insurers. However, each coastal state has different characteristics which require different models. Since 2008, DOI has been working on establishing a new panel of experts for ongoing review of models for use in South Carolina. According to a DOI employee, the panel will not have as many experts as the Florida panel and will draw from the experiences and development of the Florida model. This panel is expected to begin working to review South Carolina-specific models in Spring 2009.

Recommendations

5. The Department of Insurance should provide clear written indications of when coastal property insurance rate filings, and other documentation related to these filings, are approved or denied.

6. The Department of Insurance should include documentation in coastal property insurance rate filings of the items reviewed and the reasons for the decision.

7. The Department of Insurance should continue to encourage companies to use electronic filing, and take advantage of systems that would improve record retention and documentation as they become available.

8. The South Carolina Wind and Hail Underwriting Association should include procedures for an open, competitive process for the acceptance and cession of reinsurance in its plan of operation as required by S.C. Code §38-75-340(A)(10). The procedures should include requirements for weighting of evaluation factors, use of the evaluation factors when evaluating proposals, and consideration of price as an evaluation factor.

9. The Department of Insurance should continue ongoing review of hurricane rates and models to ensure that they are appropriate.

Overall Regulation of Insurance

The South Carolina Department of Insurance (DOI) is responsible for ensuring the solvency of insurers, protecting consumers, and regulating the insurance industry. The Office of Market Services, which is a part of the Division of Actuarial, Market and Alternative Risk Transfer Services, reviews rate and form filings to ensure that rates are not excessive, inadequate, or unfairly discriminatory, and that rules and forms used by the insurers conform with state law. The Financial Services Division monitors the financial solvency of companies that transact insurance business in the state through quarterly reviews of the financial reports submitted by domestic insurance companies. In addition, periodic examinations of each insurance company domiciled in the state are mandated by law. State law requires DOI to follow guidelines established by the National Association of Insurance Commissioners (NAIC) in conducting the reviews and examinations.

Rates, Forms, and Rules

We reviewed rate changes submitted to the department for property and casualty, as well as life, accident and health insurance products to determine whether adequate procedures were in place for analyzing the requests in order to make appropriate decisions for approval or denial. We generally found adequate support for the decisions, with two exceptions. In those two files, there were no file copies of correspondence to the requesters indicating DOI’s decisions; nor was there any documentation on file that a manager had reviewed and approved the decisions.

A primary goal of the Market Services Division of the department regarding rates is to comply with South Carolina law to ensure that insurance rates are not excessive, inadequate, or unfairly discriminatory. Any change that an insurer wants to make to its rate structure or to the forms or rules that apply to its policyholders must be submitted to the department along with supporting documentation. South Carolina statutes are applied to both domestic (South Carolina) and foreign (other states and territories) insurers when they submit requests for changes that affect insurance policies. An approved filing only applies to the company that submitted the request.

The guidelines for granting changes in rates, rules, and forms vary for life, accident and health policies, and property and casualty policies. DOI analysts use the applicable regulations, and policies and procedures manuals, for processing each submission. The manuals include state statutes and bulletins, guidelines from NAIC, and checklists that cover everything that is required when a rate request is reviewed.

An insurance company’s policy forms and rules must comply with the statutes in order to be approved by the department. Changes to any of its policies require DOI approval. A DOI official stated that the analysts never assume that the material submitted by a company is correct. The information is examined and compared to past history to see if anything unusual stands out, and the analysts verify that the math is correct and that the required documents have been received.

South Carolina has a file and use regulatory system for fire, allied lines and homeowners’ insurance policies. S.C. Code §38-73-220(A) states that “overall average rate-level increases or decreases…of seven percent above or below the insurer’s rates then in effect may take effect without prior approval on a file and use basis….” If the rate request falls within plus or minus 7% of the current rate, the insurance company may begin using that rate when the rate request is filed. DOI has 30 days to review or deny the requests before the new rates become permanent. The rate change for all insureds may average less than 7%, but the impact on some may be much higher. A DOI official explained that rate filings are regional and that rates are reviewed by territory for reasonableness. The official added that, at any one time, there may be as many as 1,700 filings outstanding.

A DOI official reported that the rates, rules, and forms program manager authorizes the final approval for all rate changes, except captives (see p. 28), and notifies the requestors of that decision. Also, disapprovals are reviewed with the agency's actuary who signs off on the decision. If the analysts recognize a trend, or if the rate or form is not compliant with filings that have previously been approved by DOI, the Office of Market Services may adjust that entry, after first consulting with the Office of General Counsel.

We reviewed a nonstatistical sample of 18 of the 1,575 rate changes that were submitted in 2007. Those files were examined to verify satisfactory analysis, evaluation, and/or appraisal in granting or denying those change requests.

Our testing was carried out to assure that each sample file was reported according to NAIC guidelines and/or state regulations. We sought to locate documentation of checklists that all necessary data was received, letters of requests with required DOI forms, rate sheets showing support for DOI decisions, actuarial memos from requesters, communications to requesters noting DOI decisions, and indications of final review and approval by the department manager. Table 2.3 lists the results of 7 tests for each of the 18 rate requests we reviewed.

Copies of the checklists and actuarial memos were located in 22% and 44% of the files, respectively. None of the files contained documentation that the requesters were notified of the final decisions on the rate requests or that the department manager reviewed and approved the final decisions.

We also reviewed one rate request that was denied. We found that there was no checklist included in the file and no evidence that the decision was approved by the DOI actuary, but there was a copy of the letter to the requester, signed by the manager of Rates and Forms, denying the request for a rate increase.

By failing to document all aspects of a rate change request, the department's decisions may not be adequately explained or supported. This is especially important if the decision is subsequently reviewed or questioned.

Table 2.3: Summary of Compliance for 18 Rate Request Samples

Criteria Tested	Number Complied
Checklist of activity supporting the decisions	4 (22%)
Original letter of request in file	17 (94%)
Required DOI forms 1504 or 2004	16 (89%)
Rates sheets submitted with the request	18 (100%)
Actuarial memo from the requesters	8 (44%)
Copies of letters to the requesters announcing final decisions	0 (0%)
Evidence that the program manager had reviewed and approved the decisions	0 (0%)

Source: DOI requests for rate change files.

Recommendations

10. The Department of Insurance should ensure that all filings include copies of checklists, actuarial memos, and communications of decisions regarding rate requests.

11. The Department of Insurance should include in all filings evidence documenting that decisions for rate changes have been reviewed and approved by a manager.

Office of Financial Analysis

We reviewed the operations of the financial analysis division to determine if the department ensures that insurance companies comply with South Carolina law and National Association of Insurance Commissioners' (NAIC) guidelines. We found that the sample files contained adequate documentation to establish that financial audits had been conducted in accordance with South Carolina laws and NAIC regulations. However, none of the samples indicated that the risk-based capital ratio had been reconciled between the company's annual statement and the NAIC calculations.

The department's Office of Financial Analysis is responsible for assuring financial solvency of companies that write insurance in the state. Financial analysts execute comprehensive reviews on each domestic insurance company. Their reviews range from assessment of actuarial opinions and amounts of premium written to monitoring financial conditions and changes in surplus. The quarterly reviews of each company's financial reports are risk-focused, and analysts use guidelines established by the NAIC, in accordance with South Carolina law, to conduct the reviews.

Licensing

The Office of Financial Analysis is also responsible for licensing new insurance companies and collecting security deposits. DOI coordinates the process for companies that apply to be licensed in South Carolina. An agency official explained that new companies must file an application, pay the fees, if any, and be reviewed by the department's Committee on Applications. This committee makes a recommendation to the director to approve or disapprove an applicant. The insurer is also required to establish its deposit before a certificate of authority may be granted. This process applies to all insurance companies, both domestic (South Carolina) and foreign (other states and territories), that apply to sell insurance in South Carolina. Thirty-nine insurance companies were licensed in 2007; only three were domestic companies.

Security deposits are based on the amount of the insurers' surplus. The deposits for insurers with a total net worth of less than $10,000,000 are considered special deposits. They are posted for the protection of South Carolina policyholders only. The S.C. Office of the State Auditor reviews the accuracy of security deposit records once a year when it examines other securities.

Procedures for the Office of Financial Analysis

DOI requires all insurers to file annual and quarterly statements of business standing and financial condition with DOI and the NAIC for the preceding financial period, as stated in S.C. Code of Laws §38-13-80 and §38-13-85. DOI financial analysts conduct audits of the financial statements filed by each domestic insurance company. The annual statement audits are more comprehensive than the quarterly reviews.

The Office of Financial Analysis conducts comprehensive financial audits for the 57 domestic companies, but less detailed reviews for foreign insurers' financial reports, unless there is a particular concern. There are approximately 1,600 foreign insurance companies licensed in South Carolina that write far more coverage than the domestic insurers.

To ensure that the states are complying with the national solvency standards, the NAIC reviews each state insurance department every five years. South Carolina may rely on other states' audits to assure solvency of foreign insurers as a part of the accreditation process.

Insurance companies are required to have a year-end audit by an independent accounting firm, prepared according to statutory accounting principles. The independent CPAs also examine the statutory statements, and make those audited statements available to DOI. Each company must also provide an actuarial opinion with its annual statement that attests that its reserves have been properly established and are adequate. DOI analysts must assume that statements are accurate and correct when they are submitted by the companies.

DOI financial analysts follow the NAIC financial checklist in assessing a company's financial solvency. Insurance companies submit their annual statements electronically to the NAIC and DOI by March 1. DOI analysts download company information from the NAIC databases, which allows DOI to sort data and compare trends for each company to assure proof of solvency.

It is not necessary for financial analysts to recalculate each NAIC report for accuracy. However, the analysts review the results of these reports for adequacy and compare them with prior quarters for trends and variations. According to DOI officials, the financial analysts mainly focus on sufficient reserves, changes in surplus, and overall financial condition.

Variations from prior reports may prompt the financial analysts to extend their appraisals. If convinced of a problem, DOI may take action by increasing the amount of the company's deposit, asking the company to stop issuing policies in South Carolina, or suspend the company's license. In such cases, the financial analysts would continue to monitor the company's performance. Once its surplus increases or the problems are resolved, the company may request to be lifted of its restriction.

According to a DOI official, at the end of each quarter, financial analysts assess companies by complexity or concern for risks for that quarter and arrange them according to urgency for the next quarter's review. The schedules are reviewed and approved by the chief financial analyst.

Investments / Reserves

According to state law, an insurance company must set aside reserves to assure that adequate capital is available to pay its claims. At year-end, a company knows how many claims it has actually paid out. Claims that have been incurred but not yet paid are calculated to determine the company's reserve liability. DOI analysts review the company's actuarial opinions to confirm the adequacy of the reserve amounts that have been established.

Each company certifies its own financial statements with a statement of actuarial opinion, including reserves and loss adjustment expenses. The calculations are verified by DOI to assure adequacy to pay future claims.

The accuracy of an insurer's investment portfolio is evaluated for conformity within the regulations. This is done by an NAIC risk model that measures the percentage of a company's investment in a security. There are many state laws that restrict the mix of an insurer's investments and the amounts that may be invested in particular securities. However, as long as the required amount of reserves are covered by highly secure investments, as required by law, the remainder of an insurer's capital may be invested as the insurer's management sees fit.

Risk-Based Capital Ratio

Insurers range widely in size and the types of risks they assume; therefore, fixed minimum capital standards may be inadequate. The NAIC adopted a model for risk-based capital (RBC) that is intended to be a minimum regulatory capital standard, but not necessarily the full amount of capital that an insurer may need to meet its safety and competitive objectives. RBC requirements provide a standard of capital adequacy that:

- Is related to risk.
- Raises the safety net for insurers.
- Is uniform among states.
- Provides authority for regulatory action when actual capital falls below the standard.

To determine if a company meets the minimum regulatory capital standards, its total adjusted capital is divided by its authorized control level risk-based capital. If this ratio is equal to or greater than 200%, an insurer is allowed to file its financials according to the NAIC standard plan. However, if the ratio falls below 200%, the insurer is subject to sanctions that range from explanations of proposed corrective actions to the Director of Insurance to seizure and liquidation of the company.

A company's annual report is public information, but details of the risk-based capital ratio calculations are confidential. Data for the ratio are gathered by the insurance company and submitted to NAIC and DOI. Insurers are required to report their risk-based capital and total adjusted capital in their annual reports. The RBC ratio is available for the public to calculate, but the sustaining criteria that supports those two numbers remain restricted. The RBC ratio calculated from the annual statement should agree with the NAIC's RBC ratio. According to an agency official and results of our test samples, the financial analysts do not recalculate the RBC ratio from the annual statement in order to confirm its agreement with the NAIC reports.

Sample Review of Financial Statements

We reviewed a random sample of 6 (11%) of the 57 financial statements from domestic insurance companies submitted during the year 2007 — one life company, one health maintenance organization, one farmers' mutual insurer, and three property and casualty companies (one surplus line, one workers' compensation, and one general insurance).

Based on the review of the six sample financial statements and discussions of the quarterly and year-end financial audit procedures with the chief financial analyst, we concur that the work of DOI financial analysts is done in accordance with the S.C. Code of Laws and NAIC regulations. There was sufficient evidence in each of the files to show that quarterly and annual statements had been reviewed by the financial analysts and the chief analyst. Sufficient copies of correspondence were in the files to assure appropriate communication between the companies and DOI. The risk-based capital ratio for each sample significantly exceeded the 200% minimum that was required.

We found that the RBC ratio, based on data from the annual statement, did not agree with the NAIC calculation in one file. When manually calculated, the ratio of the risk-based capital and total adjusted capital as shown in the annual statement was 878.8%, whereas the NAIC calculation was 866.6%. Although the difference was not significant for that insurer, the department should verify the RBC ratio for each insurance company to assure its accuracy.

Recommendation

12. The Department of Insurance should add an internal control to ensure that the risk-based capital ratio calculated by the National Association of Insurance Commissioners' financial system agrees with the ratio based on data reported in the hard copy of each domestic insurance company's annual statement.

Financial Services, Examinations

DOI financial services examinations are mandated every three to five years. However, concerns arising from the desk audits, such as any downward trend, numerous rate changes, excessive complaints, etc., identifies companies that should be watched, and may prompt more frequent examinations. It is estimated that the department examines about 12 companies each year, depending on the size of the company.

Agency officials explained that DOI can accept examination reports from other states to confirm the solvency of foreign companies that write insurance in the state. The department only audits companies domiciled in South Carolina, unless there is a need to review something on a foreign "nationally significant" company. In those cases, the examiners try to coordinate their review with the scheduled audit by the domiciliary state. If a company is domiciled in South Carolina but based in another state, its examination must be held wherever the company records are maintained.

DOI examiners review the balance sheet entries (such as investments of bonds and stocks, cash, and premiums), as well as paid claims, reserves, inter-company transactions, and funds held for reinsurance. They evaluate the materiality threshold and ensure that the surplus position of a company is fairly stated. The examiners also engage actuaries to verify the accuracy of a company's reserve calculations.

Accreditation

The NAIC Financial Accreditation Committee applies analysis and examination models when examining a state department of insurance. NAIC reviews each state every five years by examining a limited number of nationally significant companies domiciled in that state. The leaders of the NAIC audit teams are experienced individuals with significant regulatory and/or industry experience.

The NAIC performed a full accreditation review of the department in 2006, conducting interviews and evaluations of documents, procedures, and other written supporting material necessary to determine compliance with financial regulation standards. According to the *DOI Agency Accountability Report for Fiscal Year 2006-2007*, the Department was reaccredited, with Financial Examinations and Financial Analysis sections of the review receiving superior scores, demonstrating the agency's commitment to excellence.

When DOI examiners complete an exam, they write a summary and conclusion certifying that they have reviewed the financial records of the insurance company, according to state law and NAIC guidelines. A DOI official noted that DOI examination guidelines are similar to those that NAIC accreditation examiners use when the NAIC reviews the department.

Schedule of Audits

We reviewed a DOI schedule of examination audits, as of April 9, 2008, along with the department's 2008 examination schedule to ensure compliance in performing assessments of domestic insurance companies in accordance with South Carolina laws.

Table 2.4 shows the 57 domestic companies by lines of business and indicates their examination schedules. Forty-eight entries fell within the timeline for mandatory re-examinations. The remaining nine were new companies, and their mandatory examination dates were to be set after 2008.

Table 2.4: DOI Schedule of Audits as of April 9, 2008

Line of Business	Number of Domestic Companies	Maximum Years Required Between Examinations	Exams Scheduled Within 2008 Guidelines	New Companies, Will Be Scheduled After 2008
Property & Casualty	24	5	23	1
Life, Accident & Health	13	5	12	1
Title 2	2	5		0
Health Only 2	2	5		0
HMO	12	3	5	7
Other	4	1-3	4	0
TOTAL	**57**	**N/A**	**48**	**9**

Source: South Carolina Department of Insurance

We confirmed that all 57 domestic insurance companies were properly scheduled for DOI examinations, according to the laws of South Carolina.

Report of Examination

Due to the frequency of NAIC accreditation reviews that audit a sample of DOI examinations, we chose to review only one recently completed audit for compliance with South Carolina laws and NAIC requirements. We found the examination was performed in a manner consistent with the standards and procedures required by S.C. Code of Laws §38-13-10.

Captive Insurance

We reviewed the Department of Insurance's (DOI) regulation of captive insurance companies to determine how they are regulated. Captive insurance companies are a risk-financing method or form of self-insurance involving the formation of companies to serve the insurance needs of the parent companies. We found that generally the department's licensing and examinations of captives complies with state law and regulations. We did find that the department is not conducting examinations of certain types of captives, as required by law. The department also needs to continue its use of policies for conducting these examinations to ensure that the reviews include all the information and are consistent and fair.

Licensing

Captive insurance companies are insurance companies owned by parent companies whose primary purpose is to insure their owners' risk. There are several different types of captives. These are the types of captives most commonly licensed in S.C.:

- Pure captive — a company that insures only the risks of its parent and related companies. These are also referred to as "single parent" captives.
- Risk retention group (RRG) — a purchasing group of many owners in a similar business created to obtain insurance for the group in the commercial market.
- Special purpose — a captive that does not meet the definition of any other type of captive.
- Special purpose financial captive — a captive created to facilitate insurance companies' access to alternate sources of capital, for example, the need to fund reserve requirements to comply with National Association of Insurance Commissioners' rules.

As of September 2008, the department had licensed 197 captive insurance companies. Thirty-three of those captives were no longer licensed due to a variety of reasons. Table 2.5 shows the number and types of captives licensed by DOI.

Table 2.5: Types of Captives Issued Licenses by DOI as of September 2008

Type of Captive Insurance Company	Number
Association	1 (0.5%)
Branch	1 (0.5%)
Industrial	1 (0.5%)
Pure	80 (40.6%)
Risk Retention Group	60 (30.5%)
Special Purpose	27 (13.7%)
Special Purpose Financial	23 (11.7%)
Sponsored	4 (2.0%)
TOTAL	**197 (100%)**

Source: South Carolina Department of Insurance

To be licensed in South Carolina, captives have to file certain information with the department. We reviewed a nonstatistical sample of 6 (27%) of the 22 captives licensed in 2007, excluding special purpose financial captives, to determine if the companies had been licensed in accordance with state law and department policies. Two of the captives we reviewed have not conducted any business and have not yet complied with all of the licensing requirements.

We found that the licenses for the four companies that had begun operations had generally been issued in compliance with the law and policies. However, we found that two companies did not have evidence in the form of a bank statement or letter of credit that the captive had met the capital and surplus requirements in the law. The department accepts a copy of a certified balance sheet signed by two officers of the company as proof that the captive met the financial requirements. S.C. Code §38-90-40(A)(2)(a) requires that the capital be in the form of cash, cash equivalent, or an irrevocable letter of credit. Additionally, we found that:

- One company did not have a certified copy of its bylaws as required by S.C. Code §38-90-20(C).
- Two companies had not had an organizational examination done by the department as required by department policy.

When the department does not obtain all of the required information from captives, there is less assurance that the company will be able to fulfill its purpose and protect the interests of its parent company. It is particularly important for financial information so that the department can ensure that the captive is adequately funded and can remain solvent. For RRGs, which include members of a similar profession, the department should ensure that it has all of the required information to protect the members.

Recommendation

13. The Department of Insurance should ensure that all captive insurance companies issued licenses provide all information required by state law and department policies.

Examinations

After a captive insurance company is licensed, S.C. Code §38-90-80(A) requires the department to examine each captive, at least once in three years, to determine "its financial condition, its ability to fulfill its obligations, and whether it has complied with [the law]." Risk retention groups and special purpose financial captives are examined in compliance with the National Association of Insurance Commissioners guidelines (see p. 26). All other captives are reviewed as determined by the department.

In the review of captive insurance companies, we found that DOI did not have standard procedures for conducting reviews of captives that are not risk retention groups or special purpose financial captives and had not always completed the reviews in the time period required by state law. The department has now developed standard guidelines to conduct these examinations and, according to a DOI official, began using the guidelines in December 2008. We also reviewed four of the examinations which the department had completed. Those examinations included adequate documentation to determine that the captive was operating in compliance with state law. However, we reviewed DOI's schedule of examination dates for captives and found that 43 (81%) of 53 reviews had not been completed within the three-year period required by state law. By not having procedures and failing to complete examinations as required by law, there is less assurance that the captive insurance companies are able to meet their financial obligations.

We also reviewed the examinations of the risk retention groups (RRGs). These captives must be reviewed in accordance with the National Association of Insurance Commissioners (NAIC) guidelines (see p. 26). NAIC also conducts accreditation reviews of the department which includes looking at the examinations of the RRGs done by the department. NAIC reaccredited DOI in 2006 after the review. We reviewed four examinations and analyses of RRGs conducted by the department and found that the reviews were adequate to ensure that the RRGs were operating in accordance with state law. We also reviewed DOI's schedule of examination dates for RRGs and found that 3 (8%) of 36 reviews had not been completed within the three-year period required by state law.

Recommendations

14. The Department of Insurance should continue using its guidelines for conducting examinations of captive insurance companies.

15. The Department of Insurance should conduct examinations of captive insurance companies within the three-year period required by S.C. Code §38-90-80(A).

Agency Comments

South Carolina Department of Insurance

MARK SANFORD
Governor

SCOTT H. RICHARDSON
Director of Insurance

June 19, 2009

Thomas J. Bardin, Director
Legislative Audit Council
1331 Elmwood Avenue, Suite 315
Columbia, South Carolina 29201

Dear Mr. Bardin:

Thank you for the opportunity to comment on your audit report entitled *A Review of the Department of Insurance*. We appreciate your general recognition that the Department "regulates the insurance industry appropriately."

While we welcome some of the corrections made following our initial response, the Department remains concerned by some of the report's content. Overall, the report does not put matters in the proper timeframe nor context. As a result, people reading the report may mistakenly conclude that the issues cited are more pervasive than they are or exist today whereas many do not. The report does not adequately reflect current procedures nor the changes this Department has made to improve its overall regulation of the South Carolina insurance industry.

The most troubling comments occur in the Workers' Compensation Insurance summary where the report cites that DOI had information missing from many of its files. The report does not adequately explain: 1) that the regulatory requirements in effect during the period reviewed resulted in three distinct periods of filing requirements; 2) that many of the filings reviewed did not require submission nor approval by the Department and were obtained as a part of the DOI's audit of loss cost multipliers; or 3) that information deemed to be missing was not in some files because it was not required or necessary for the filing. We do not profess to be a perfect agency; however, the omission of summary documentation does not mean a filing was not reviewed in accordance with state law. Moreover, the omission of these documents did not compromise the solvency of any insurer or the rate review process.

We are also concerned that although we provided the documentary evidence to disprove a number of the report's conclusions in your report and to clarify others by putting them in the proper context, many of the findings and conclusions did not change. We offer this response as further clarification of sections we believe contain erroneous or misleading information.

It is important to note that many of the issues cited in this report are ones DOI brought to the attention of the auditors and many of LAC's recommendations are based on actions the Department had taken to address those issues. The remaining recommendations are in the process of being implemented by the Department. As we indicated previously, this Department welcomes suggestions for improvement, and with the help and support of the General Assembly, has been able to acquire some of the resources necessary to further enhance our regulatory services to this state's citizens. What follows is a more detailed response to some of the content found in the **EXECUTIVE SUMMARY** of the report.

WORKERS' COMPENSATION INSURANCE

Report conclusion: Ninety seven percent (97%) of the files reviewed had missing information.

DOI Response: This conclusion is incorrect because:

- It does not clearly differentiate between the filings that required certain information and those that did not. The report subsequently acknowledges that 55% of the filings reviewed were exempt from filing and prior approval per South Carolina law. As we recommended, the report should have focused its review on the remaining 34 filings or chosen additional files that were not exempt as a part of the sample.
- It does not clearly define the information that was missing from each of the files. In most instances, it appeared to be a checklist or other summary documentation that described the review of the file. The Department had already incorporated a requirement that analysts use checklists to review filings as evidenced by the planning stage documents provided to the audit team.

(Continued)

Report Conclusion: State law allows insurers to use any year's loss costs data when calculating rates. State law should be amended to require insurers to use the most recently approved loss costs data when calculating rates.
DOI Response: The Department brought this issue to the attention of the audit team and recommended this law change in a December 2008 report on workers' compensation insurance to the General Assembly. Draft language has been provided to the General Assembly.

COASTAL PROPERTY INSURANCE
Report Conclusion: Nine (9) of 36 files had no evidence of DOI's review. Completing checklists that DOI already has and including them in the file would show that the Department is evaluating all aspects of the filing and how it reached its decision...
DOI Response: Department analysts do review all aspects of the filing and that analysis is reviewed by the program manager and actuaries, where appropriate. Analysts are required to use checklists as a part of their analysis. Going forward, the program manager will be reviewing each filing to ensure the checklists are being completed and included with each filing.

OVERALL REGULATION OF INSURANCE
Report Conclusion: None of the samples indicated that the risk based capital ratio had been agreed between the company's annual statement and NAIC calculations.
DOI Response: As the Department's initial response detailed, the software utilized by this Department automatically reconciles the RBC ratio and it is subsequently verified by the NAIC.

CAPTIVE INSURANCE
Report Conclusion: The Department did not collect all of the required information from companies.
DOI Response: The information has since been added to the file. In addition, DOI is currently auditing all licensing files to ensure that all required information is collected and properly filed.

Report Conclusion: The Department did not have standard procedures for conducting the financial examinations of captives that are not risk retention groups or special purpose financial captives.
DOI Response: The Department did have procedures for conducting these examinations. The Department previously used the NAIC procedures for examining "traditional" insurance companies for these groups. In 2008, DOI developed examination procedures designed to target the complexity and size of pure captive insurance companies.

Report Conclusion: We reviewed the DOI's schedule of examination dates and found that 43 reviews had not been completed within the three-year period required by law.
DOI Response: The examinations referenced generally involved only the commercial policyholder that created the captive insurer, thus limiting the loss resulting from any potential failure to that commercial entity, without adverse effects on the general public. The Department had to prioritize its available resources and chose to focus on the examination of RRGs because they often sell products to the public. As the Department's initial response indicated, some of these examinations were not performed timely because we were coordinating the examination with another domiciliary state. Others were not completed within the three-year statutory timeframe due to a lack of regulatory resources. In these instances, the Department relied upon the company's yearly financial audits, which must be conducted by a certified CPA, and the actuarial review of the company's reserves as required by South Carolina law. Notwithstanding, the Department has scheduled all outstanding examinations and anticipates their completion by June 30, 2010.

The Department's response to the other sections of the report and recommendations are set forth in the pages that follow. Please do not hesitate to contact me or my staff if you have any questions.

Sincerely,

Scott H. Richardson, CPCU
Director

Recommendations

What follows is the Department's response to each of the recommendations contained in the report.

1. *The Department of Insurance should require insurers to provide all necessary information on workers' compensation filings and should retain copies of this information.*
   ➢ **Response**: This is already required as set forth in Bulletins 2007-13, 2007-13B, and 2008-10. If a company submits a filing without the necessary information, the information is requested. If the filing remains incomplete, it is disapproved or the company withdraws it and resubmits a complete filing.

2. *The Department should maintain copies of checklists, actuarial memos and communications of decisions regarding workers' compensation filings.*
   ➢ **Response**: DOI does maintain checklists, actuarial memos and communications of decisions where applicable. These documents are being scanned into DOI's electronic filing systems in order to improve record retention.

3. *The Department should document evidence that decisions for workers' compensation filings have been reviewed and approved.*
   ➢ **Response**: These decisions are reviewed and approved by the assigned actuary, documented by a memo from the actuary, and are being scanned into DOI's electronic filing systems in order to improve record retention.

4. *The General Assembly should amend Title 38, Chapter 73 by adding a section requiring all workers' compensation insurers to use the most recently approved loss cost data when determining rates.*
   ➢ **Response**: The Department brought this issue to the attention of the audit team, recommended this law change in a December 2008 report on workers' compensation insurance to the General Assembly, and has submitted draft legislation to this effect.

5. *The Department should provide clear written indication of when coastal property insurance rate filings, and other documentation related to those filings, are approved or denied.*
   ➢ **Response**: This is already done on all filings, except those exempt from prior approval. Filings are stamped or electronically updated and the status of the filing, along with the Department's action, is entered into SERFF, the State Electronic Rates and Forms Filing system, and into the IA Folder (the scanning system) for paper filings.

6. *The Department of Insurance should include documentation in coastal property insurance rate filings of the items reviewed and the reasons for the decision.*
   ➢ **Response**: This is already done for all filings subject to review and approval by DOI as noted in the response to Recommendation No. 2.

7. *The Department of Insurance should encourage companies to use electronic filings and take advantage of the systems that would improve record retention and documentation as they become available.*
   ➢ **Response**: DOI does encourage electronic filings. As LAC noted, 78% of the filings reviewed were submitted electronically.

8. *The SCWHUA should include procedures for an open, competitive process for the acceptance and cession of reinsurance in its plan of operation as required by S.C. Code § 38-73-340 (A)(10).*
   ➢ **Response**: SCWHUA plans to file an amendment to its plan of operation with DOI to address this finding.

9. *The Department should continue ongoing review of hurricane rates and models to ensure they are appropriate.*
   ➢ **Response**: This recommendation is consistent with the Department's plans.

10. *The Department of Insurance should ensure that all filings include copies of checklists, actuarial memos, and communications of decisions regarding rate requests.*
    ➢ **Response**: DOI does maintain checklists, actuarial memos and communications of decisions where applicable. These documents are being scanned into the Department's electronic filing systems in order to improve record retention. In addition, all analysts are required to use and include checklists with each filing. The program manager will be verifying the analyst's compliance upon signing off on each filing.

11. *The Department of Insurance should include in all filings evidence documenting that decisions for rate changes have been reviewed and approved by a manager.*
   ➢ **Response**: This is already done. The program manager reviews the filing and includes her notes in SERFF for the electronic filings and on the filing summary scanned into the IA Folder for the paper filings. DOI plans to amend the filing checklists to add signature lines for the analyst and the program manager as additional documentation.

12. *The Department of Insurance should add an internal control to ensure that the RBC ratio calculated by the NAIC's financial system agrees with the ratio based on data in the hard copy of each domestic insurer's annual statement.*
   ➢ **Response**: This is already done using the electronic copy. The Department relies on the annual statement submitted electronically in conducting our analysis and review. The software utilized when conducting this review automatically reconciles the RBC ratio and it is subsequently verified by the NAIC. In the instance to which this recommendation applies, the Department revised and initialed the RBC on the insurer's hard copy filing and received verification from the insurer that the company had submitted the wrong hard copy of the report.

13. *The Department should ensure that all captive insurance companies issued licenses provide all information required by state law and departmental policies.*
   ➢ **Response**: The Department is reviewing its licensing procedures and auditing all licensing files to ensure that all required information is collected and properly filed.

14. *The Department should continue using its guidelines for conducting examinations of captive insurance companies.*
   ➢ **Response**: This is consistent with the Department's plans.

15. *The Department of Insurance should conduct examinations of captive insurance companies within the three-year period required by S.C. Code §38-90-80(A).*
   ➢ **Response**: DOI has scheduled all outstanding examinations and anticipates their completion by June 30, 2010. DOI will conduct all future examinations in accordance with the examination timeframes set forth in state law.

What follows is the Department's response to some of the issues raised in the report by section.

WORKERS' COMPENSATION INSURANCE

LAC did not acknowledge that there were three periods of regulatory requirements over the nine years of filings reviewed. Consequently, they did not distinguish in their findings which regulatory framework was in place at the time a filing was made. Prior to 2003, DOI approval was required for workers' compensation insurers' loss cost multipliers and, by extension, their classification manual rates. Regulation 69-64, effective in 2003, exempted loss cost multipliers from filing and prior approval by the Department. Insurers were required to maintain desk file copies of their filings and, upon DOI's request, to submit their filings for review. In 2006, DOI issued a data call to all insurers writing workers' compensation insurance for a copy of their desk filing. Based on this review, DOI made recommendations to the General Assembly for workers' compensation insurance reform. In June 2007, S.C. Act No. 111 reformed the state's workers' compensation insurance laws. S.C. Code Section 38-73-525 now requires insurers to submit loss cost multipliers and manual classification rates to the Department for prior approval.

Report: We found that 97% of the rate filings reviewed had missing information including financial data, actuarial review, and approval details. However, the department reports that 41 (55%) of these filings were between June 2003 and June 2007 and thus, exempt from filing submission and prior approval.
Response: LAC included exempt filings in their sample and subsequent findings of missing data as reported in Table 2.2 (p.12). Because of this, LAC's reported finding that 97% of the rate filings reviewed had missing information is misleading and inaccurate. Of the 75 filings reviewed, 41 (55%) were exempt pursuant to Regulation 69-64, meaning that no such information or prior review was required. Of the remaining 34 filings, 29 (85%) were dated 2000 to 2002 and the available information indicates that the majority of these filings were for an insurer's adoption of approved loss costs and changes to the LCMs. Not all of the information cited as missing was required or necessary for review of an insurer's adoption of loss costs because they are filing to adopt loss costs that have already been approved and extensively reviewed by this Department. Additionally, no actuarial review was required for LCM filings during this period. The financial data was available through the annual statement to test the reasonableness of the expense components. However, some of these filings did not include all information as detailed in Updated Table 2.2 on Page 5.

The remaining 5 (14%) filings were submitted between 2007 and 2008. LAC found two to have been properly reviewed. LAC contends that no effective date was indicated in two filings, but these two are electronic SERFF filings and do in fact include an effective date in the filing. Moreover, the effective date for a filing is the date it is approved by the Department unless the insurer requests an alternate later date. LAC found the final filing to be missing an account for the Second Injury Fund assessment. The Department has revised Table 2.2 to more accurately reflect the information that should have been in the filings reviewed by LAC based upon the regulatory framework in place at the time of the filing. A more detailed chart illustrating this point is enclosed. A similar chart was included in our previous response.

Updated Table 2.2	**Percentage of Missing Documentation in Workers' Compensation Filings**					
	5 Filings from 2007-2008 *Prior Approval Required*		**41 Filings from 2003 - 2007** *Exempt from Filing or Prior Approval*		**29 Filings from 2000-2002** *Prior Approval Required*	
DOCUMENTATION	MISSING	PRESENT	MISSING	PRESENT	MISSING	PRESENT
Actuarial Review	0	100%	Exempt	Exempt	N/A	N/A
Second Injury Fund	20%	80%	Exempt	Exempt	31%	69%
Financial Exhibits	0	100%	Exempt	Exempt	35%	65%
Approved Date/Status	0	100%	Exempt	Exempt	14%	86%
Effective Date Change	0	100%	Exempt	Exempt	14%	86%

RATE REGULATION SECTION

Report: The LCM has increased over 30% from 2000 to 2006.
Response: Since reinstatement of the prior approval requirement by 2007 S.C. Act No. 111, the average LCM has been decreasing. From August 2007 to June 18, 2009, the average LCM has decreased approximately 10%.

Report: A survey by the Oregon Department of Consumer and Business Services suggested that in 1998, South Carolina had the lowest workers' compensation rates in the country. By 2006, South Carolina's rates ranked 25th nationally and in 2008, South Carolina ranked 12th. In the eleven year period between 1998 and 2008, the workers' compensation rates in South Carolina have gone from the lowest in the country to some of the highest.
Response: The Oregon study cautions that, when comparing the study's results by state, a number of issues should be considered. These include the states' workers' compensation systems and payroll distributions. A more appropriate figure to consider than the report's state rankings is the current average voluntary pure loss costs using South Carolina's payroll distribution in comparison to other southeastern states. According to NCCI, the most recent year's data (2007) indicates that South Carolina's rate is $1.73 per $100 in payroll, lower than the region's average of $1.80.

Report: DOI was unable to provide an exhaustive list of all workers' compensation filings between 2000 and 2007.
Response: The Department did provide a list of all workers' compensation insurance filings for the period 2000 to early 2009, totaling over 1,400 filings.

Report: There were many files that had no stamps and it was unclear if these files were reviewed at all. In their procedural binder, DOI provided us with a checklist that it used to review all filings. However, there was no evidence of this or any checklist within any of the files reviewed, nor were there any notations regarding who specifically reviewed the file or when it was reviewed.
Response: As previously noted, for 55% of the files reviewed, no filing or prior approval review was required because LCM filings were exempt by South Carolina law from 2003 to 2007. If the file was not required to be received nor approved, it would not have been reviewed with or without a checklist.

Report: Without a summary document or checklist in every filing, as well as the appropriate information from insurers, it was difficult to determine if the appropriate analysis or any analysis was conducted by the Department. From June 2003 through June 2007, the department did not regulate rates and loss cost multipliers of insurers providing workers' compensation coverage. Therefore, for some of the files reviewed, DOI reported that no analysis was required, as these filings were exempt from review.
Response: The Department did regulate rates during the period of June 2003 to July 2007 – DOI continued to regulate the prospective loss costs filings (which were and still are subject to prior approval) and conducted an audit of LCMs in 2006. The appropriate analysis was conducted on the filings subject to prior approval. As LAC correctly points out, no analysis was required as many of the sample's filings were exempt from filing and prior approval.

Coastal Property Insurance

Background Section

Report: In South Carolina, over 32,000 personal coastal property insurance policies were cancelled from January 2006 through September 2008, according to DOI's SCWHUA Status Report for 2008. Some of the policies appear to be shifting from including wind coverage to excluding wind coverage.

- The total number of new and renewal policies with wind coverage has decreased from 83,000 in January 2006 to almost 73,500 as of September 2008, a decrease of 11%.
- The total number of new and renewal policies written without wind coverage has increased from 67,000 in January 2006 to almost 88,500 in September 2008, an increase of 32%.

Response: Following an in-depth review of coastal market conditions, specifically the availability and affordability of coverage in the coastal area, the Director of Insurance expanded the territory covered by SCWHUA, the state's residual market, in 2007. The admitted property insurance market is inter-dependent on the SCWHUA. Following the territory expansion, DOI issued a data call to all coastal property insurers in order to determine the impact of the territory expansion on the coastal property insurance market. The data call requires insurers to submit quarterly reports on coastal property insurance issued with wind and hail coverage and coastal property insurance issued without such coverage, allowing the Department to closely monitor changes to each insurer's book of business. Following receipt of information for the period January 2006 to September 2008, DOI included a report on the coastal property insurance marketplace in its SCWHUA Status Report for 2008 to the General Assembly. The Department's report focused on a comparative analysis of the trends and changes in the marketplace, including changes in the number of total policies in force, new policies written, policies renewed, and insurer-initiated cancellations by month. This analysis was performed for both the personal lines and commercial lines markets. By contrast, LAC reported on the number of cancellations in the personal lines market over the 33-month period. While the reported figure is mathematically correct, this figure alone provides no comparative analysis nor explanation of any changes in the marketplace. Additionally, the LAC should have reported on policies and trends in the commercial lines marketplace in its review.

LAC should have analyzed the total number of policies in force with wind coverage versus the total number of policies in force without wind coverage and any changes in these figures. As DOI reported in its Status Report, the total number of personal lines insurance policies in force with wind in the voluntary market is declining. Conversely, the total number of commercial lines policies in force with wind in the voluntary market increased over the same period:

- The total number of personal lines insurance policies in force with wind coverage has decreased from 83,168 in January 2006 to 73, 466 as of September 2008, a decrease of 11.7%.
- The total number of personal lines insurance policies in force without wind coverage has increased from 67,672 in January 2006 to 88,462 in September 2008, an increase of 30.7%.
- The total number of commercial lines insurance policies in force with wind coverage has increased from 2,954 in January 2006 to 3,904 as of September 2008, an increase of 32.16%.
- The total number of commercial lines insurance policies in force without wind coverage has also increased, from 853 in January 2006 to 1,227 as of September 2008, an increase of 43.85%.

Regulation Section

Report: Nine of 36 filings had no evidence of DOI's review or an explanation of its decision. For two files, DOI did not clearly indicate in the file what decision had been made... Although the files included evidence that the department had reviewed the filings, there was often no evidence in the files of what the department reviewed to evaluate the filings or how the decisions were made. DOI should follow the checklists when reviewing filings to ensure that... all rate increase requests are appropriate and justified...

Response: DOI provided 36 filings for review in response to LAC's random selection procedure. This section of the report and its conclusions appear to address homeowners' insurance rate filings. However, only seven of the 36 filings were rate filings for homeowners' or mobile home insurance. Four of these seven filings had no rate impact, meaning only three (8%) of the 36 filings reviewed were representative of homeowners' insurance rate filings. Two of the three filings were approved as amended, meaning these filings included documented correspondence between DOI and the insurer to resolve the issues related to the filing. As LAC noted, the Department "required further information from companies that requested rate increases when the department was not convinced that the increased rates should be approved." The final homeowners' insurance rate filing was for adoption of loss costs, for which no actuarial review is required. The breakdown of the filings provided for LAC review is detailed in the chart on Page 7. As noted on the chart, three of the filings were still open and in the process of being reviewed when requested by LAC.

Filing Count	% of Filings Reviewed	Line of Business	Type of Filing	Disposition	Comments
11	31%	Homeowners	Form or Rule	Approved as Amended	No rate impact
9	25%	Fire/Allied Lines	Form or Rule	Use and File	No rate impact
2	6%	Commercial Multiple Peril & Condo	Form or Rule	Use and File	No rate impact
1	3%	Automobile	Form, Rate, Rule	Approved as Amended	Not homeowners
2	6%	Fire/Allied Lines	Rule/Rate	Use and File	Not homeowners
1	3%	Farmowners Multiple Peril	Rule/Rate	Approved	Not homeowners
3	8%	-	-	N/A	Open
29	**81%**	**Not Homeowners' Insurance Rate Filings**			
4	11%	Homeowners	Form, Rate, Rule	Approved / Disapproved	No rate impact
3	8%	Mobile Home Homeowners Homeowners	Form, Rate Rate Rate	Approved as Amended Approved as Amended Approved	Documentation Included Documentation Included Adoption of Loss Cost
7	**19%**	**Homeowners'/ Mobile Home Insurance Rate Filings**			

<u>SOUTH CAROLINA WIND POOL SECTION</u>

Report: The 2007 SCWHUA filing resulted in a 35% overall premium increase. There was no evidence in the file of DOI staff review of the request. There was no evidence in the file of an actuarial review or of DOI's approval of the rate filing. In order to ensure consistent review of SCWHUA filings, DOI should document its review of the filings with the same documentation recommended for all coastal property insurance filings.

Response: The Rates and Forms program manager and the Director of Insurance reviewed the filing, including a review of the near- and long-term parameters, modeled results, territory analysis, and changes by interval presented in the filing. The two catastrophe models used by the SCWHUA presented a rate indication ranging from an increase of 61.2% to 366.3%. This review occurred over a period of 23 business days and included follow-up inquiries and a meeting with the executive director of the SCWHUA, the Consumer Advocate, the Consumer Advocate's actuary, and a consultant for the SCWHUA. The Department concluded that a 35% overall increase in rates was both adequate to support the SCWHUA's operations and not excessive nor unfairly discriminatory.

Report: In order to ensure consistent review of SCWHUA filings, DOI should document its review of the filings with the same documentation recommended for all coastal property insurance filings.

Response: The filing was prepared by an associate actuary on behalf of SCWHUA. DOI already requires analysts to follow the same procedures relating to checklists and documentation when reviewing SCWHUA filings as are required for all property insurance filings. Analysts are required to use checklists and to include them with the file. The program manager will verify the analyst's compliance upon signing off on each filing to ensure the checklists are being used and completed for each file. The program manager reviews the filing and includes her notes in SERFF for the electronic filings and on the file summary scanned into the IA Folder for paper filings. To further ensure such documentation, DOI plans to amend the filing checklists to add signature lines for the analyst and the program manager.

<u>CHANGES TO COASTAL PROPERTY INSURANCE REGULATION</u>

Report: DOI has been working on establishing a new panel of experts for ongoing review of models for use in South Carolina... This panel is expected to begin working to review South Carolina-specific models in Spring 2009.

Response: We have begun the solicitation process for expert panelists and anticipate its completion by September 2009.

OVERALL REGULATION OF INSURANCE

<u>RATES, FORMS, AND RULES SECTION</u>

Report: Copies of the checklists and actuarial memos were located in 22% and 44% of the files, respectively. None of the files contained documentation that the requesters were notified of the final decisions on the rate requests or that the department manager reviewed and approved the final decisions.

Response: Most of the filings are submitted electronically and decisions are also transmitted in that manner. The Department provided access to the SERFF system and a copy of the summary screen from our database which provided information about the action taken on the filing. Copies of letters to insurers have also been scanned along with the filing into the Department's electronic filing system in order to improve record retention. Analysts are required to prepare and include a checklist in each of the files – in SERFF for electronic filings and in the IA Folder for paper filings.

Report: We also reviewed one rate request that was denied. We found that there was no checklist included in the file and no evidence that the decision was approved by the DOI actuary, but there was a copy of the letter to the requester, signed by the manager of Rates and Forms, denying the request for a rate increase.
Response: The Department provided information evidencing that each analyst is required to complete a checklist for each filing reviewed. The program manager will verify each analyst's compliance upon signing off on each filing to ensure the checklists are being used and included with each file. To further ensure such documentation, DOI plans to amend the filing checklists to add signature lines for the analyst and the program manager.

RISK-BASED CAPITAL RATIO/ SAMPLE REVIEW OF FINANCIAL STATEMENTS SECTIONS
Report: The RBC ratio calculated from the annual statement should agree with the NAIC's RBC ratio... We found that the RBC ratio, based on data from the annual statement, did not agree with the NAIC calculation in one file. When manually calculated, the ratio of the risk-based capital and total adjusted capital as shown in the annual statement was 878.8%, whereas the NAIC calculation was 866.6%. Although the difference was not significant for that insurer, the department should verify the RBC ratio for each insurance company to assure its accuracy.
Response: DOI relies on the annual statement submitted electronically in conducting our analysis and review. The RBC ratio is reconciled with the information in the insurer's annual statement filed electronically with the NAIC and checked against other databases maintained by the NAIC. This reconciliation is performed automatically by the software, which is maintained by the NAIC who routinely performs quality checks on the data. In the instance to which this recommendation applies, the Department revised and initialed the RBC on the insurer's hard copy filing and received verification from the insurer that the company had submitted the wrong hard copy of the report.

CAPTIVE INSURANCE COMPANIES

LICENSING SECTION
Report: Two companies had not had an organizational examination done as required by department policy.
Response: South Carolina law does not require an organizational exam to be conducted. According to Department policy, such an examination is generally performed to further ensure that the captive is complying with state law. Due to resource limitations, the Department has generally tried to confirm the existence of the documents the Department would check for during an organizational examination as a part of the licensing process. In addition, the Department is reviewing its licensing procedures and auditing all licensing files to ensure that all required information is collected and properly filed.

EXAMINATIONS SECTION
Report: We reviewed DOI's schedule of examination dates for captives and found that 43 of 53 reviews had not been completed within the three-year period required by state law.
Response: As our initial response indicated, some of these examinations were not performed timely because we are coordinating the examination with another domiciliary state. Others were not completed within the three-year statutory timeframe due to a lack of regulatory resources. DOI had to prioritize its available resources and chose to focus on the examination of RRGs because they often sell products to the public. The examinations referenced generally involved only the commercial policyholder that created the captive insurer, thus limiting the loss resulting from any potential failure to that commercial entity, without adverse effects on the general public. State law requires captive insurers to have a certified CPA comprehensive financial audit each year. Additionally, an actuarial review of the captive's reserves must be conducted by a DOI-approved actuary. DOI relied upon these factors in making the decision to focus its examination resources on RRGs organized as captives. DOI has scheduled the outstanding examinations and anticipates their completion by June 30, 2010. Future examinations will be conducted in accordance with the statutory timeframes for examinations.

Report: We reviewed DOI's schedule of examination dates for RRGs and found that 3 of 36 had not been completed within the three-year period required by state law.
Response: The examinations for these three RRGs were not performed during the three-year statutory timeframe due to DOI's interpretation of the phrase "commencing business" as meaning when the company began writing business. However, the NAIC has since provided guidance that defines the term as the date of licensure, regardless of whether the company has conducted any business. The Department has revised its schedule of RRG examinations accordingly.

Workers' Compensation Filings Reviewed by LAC

75 Filings in Sample: 41 filings (55%) were exempt from filing or review by DOI, leaving 34 filings (45%) eligible for review

Company	Filing Year	Filing Description	Approval Date	Effective Date	LAC Comment	DOI Response	DOI Manager
Prior Approval Required [2007-2008] 5 (15%) of 34 filings eligible for review							
Key Risk Insurance Company	2008	Revise LCM	1/28/08, Closed FIO (desk file, Date N/A)	1/28/08, Closed FIO (desk file, Date N/A)	No Comment	Desk File	C. Griffin
Westfield National Insurance Company	2007	Initial Adoption of NCCI loss costs & LCM	Approved12/07/07	12/07/2007	No Comment	Filing complete	C. Griffin
Eastern Alliance Insurance Company	2007	Initial Adoption of NCCI loss costs & LCM	Approved 12/06/07	12/06/2007	No Approval Date	SERFF Filing - Electronic	C. Griffin
Seneca Insurance Company	2007	Initial Adoption of NCCI loss costs & LCM	Approved 01/31/08	01/31/2008	No SIF	Expense factor needed	C. Griffin
SPARTA Insurance Company	2007	Initial Adoption of NCCI loss costs & LCM	Approved 05/22/08	05/22/2008	No Approval Date	SERFF Filing - Electronic	C. Griffin
Exempt Filings [2003-2007] 41 (55%) of the 75 filings selected by LAC for review							
Travelers Indemnity Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Property Casualty Co. of America	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
NIPPONKOA Ins. Company, Limited	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Fire and Marine Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Phoenix Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Guardian Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company of America	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Mercury Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Farmington Casualty Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
The Standard Fire Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Athena Assurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Casualty and Surety Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Charter Oak Fire Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Protective Insurance Company	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company of Connecticut	2007	Adopt NCCI 10/06 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Hartford Insurance Company of the Midwest	2007	Filing Desk Copies of Current LCMs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Builders Mutual Insurance Company	2006	Adopt NCCI 4/1/03 loss costs & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
State Auto Property & Casualty Insurance Company	2005	Filing large deductible endorsement	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
State Auto Mutual Insurance Company	2005	Filing large deductible endorsement	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Commerce and Industry Insurance Company	2004	Modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Companion Property and Casualty Insurance Company	2003	Adopt NCCI's 4/1/03 loss cost change and modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Hartford Underwriters Insurance Company	2003	Adopt NCCI's 4/1/03 loss cost change and modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Twin City Fire Insurance Company	2003	Adopt NCCI's 4/1/03 loss cost change and modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Charter Oak Fire Insurance Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company of Connecticut	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company of America	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Phoenix Insurance Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Indemnity Company of Illinois	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Casualty and Surety Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Travelers Insurance Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
NIPPONKOA Insurance Company	2003	Adopt NCCI 4/1/03 loss cost & modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Builders Mutual Insurance Company	2003	Modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Builders Mutual Insurance Company	2003	Modify LCM	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Fire and Marine Insurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Mercury Insurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Guardian Insurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Athena Assurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
St. Paul Medical Liability Insurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Northbrook Property and Casualty Insurance Company	2003	Adopt the 4/1/03 NCCI loss costs	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Key Risk Insurance Company	2003	Desk filing from 2003	Exempt	Exempt	LAC Commented	Comments Not Applicable	NA
Prior Approval Required - Archived Records [2000-2002] 29 (85%) of 34 filings eligible for review							
Hartford Underwriters Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 2/26/02	Approved 3/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Capital City Insurance Company	2002	Modify LCM	Withdrawn 11/25/02, Approved 12/18/02	Withdrawn 11/25/02, Approved 12/18/02	No Approval Date/Actuarial and/or Financial Data	Missing only financial data	D. Kruger
Builders Mutual Insurance Company	2002	Modify LCM	Approved 3/7/02, Approved 4/10/02	Approved 3/7/02, Approved 4/10/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger

Workers' Compensation Filings Reviewed by LAC

75 Filings in Sample: 41 filings (55%) were exempt from filing or review by DOI, leaving 34 filings (45%) eligible for review

Company	Filing Year	Filing Description	Approval Date	Effective Date	LAC Comment	DOI Response	DOI Manager
Prior Approval Required - Archived Records [2000-2002] 29 (85%) of 34 filings eligible for review ***Continued from previous page***							
Travelers Indemnity Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Charter Oak Fire Indemnity Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Travelers Indemnity Company of Connecticut	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Travelers Indemnity Company of America	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Phoenix Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Travelers Indemnity Company of Illinois	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Travelers Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Travelers Casualty & Surety Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
NIPPONKOA Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/6/02, Approved 1/21/03	Approved 3/6/02, Approved 1/21/03	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
St. Paul Fire and Marine Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
St. Paul Mercury Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
St. Paul Guardian Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Athena Assurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
St. Paul Medical Liability Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Northbrook Property and Casualty Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 3/26/02	Approved 7/1/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Liberty Mutual Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 4/11/02	06/01/2002	No Approval Date/Actuarial and/or Financial Data	Financial and SIF data needed	D. Kruger
Liberty Mutual Fire Insurance Company	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 4/11/02	06/01/2002	No Approval Date/Actuarial and/or Financial Data	Financial and SIF data needed	D. Kruger
LM Insurance Corporation	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 4/11/02	06/01/2002	No Approval Date/Actuarial and/or Financial Data	Financial and SIF data needed	D. Kruger
The First Liberty Insurance Corporation	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 4/11/02	06/01/2002	No Approval Date/Actuarial and/or Financial Data	Financial and SIF data needed	D. Kruger
Liberty Insurance Corporation	2002	Adopt the 12/1/01 NCCI loss costs & modify LCM	Approved 4/11/02	06/01/2002	No Approval Date/Actuarial and/or Financial Data	Financial and SIF data needed	D. Kruger
Capital City Insurance Company	2001	Modify LCM	Approved 11/27/00	Approved 11/27/00	No Approval Date/Actuarial and/or Financial Data	All data required	D. Kruger
Commerce and Industry Insurance Company	2001	Copy of LCM form	Approved 2/6/02	Approved 2/6/02	No Approval Date/Actuarial and/or Financial Data	All data required	D. Kruger
American Home Assurance Company	2001	Copy of LCM form	Approved 2/6/02	Approved 2/6/02	No Approval Date/Actuarial and/or Financial Data	All data required	D. Kruger
Commerce and Industry Insurance Company	2000	Copy of LCM form	Approved 12/11/00	Approved 2/6/02	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger
Liberty Mutual Fire Insurance Company	2000	Copy of LCM form	Approved 06/23/00	Approved 01/01/01	No Approval Date/Actuarial and/or Financial Data	All data required	D. Kruger
Builders Mutual Insurance Company	2000	Adopt NCCI loss cost filing - Initial Filing	Approved 11/30/00	Approved 12/1/00	No Approval Date/Actuarial and/or Financial Data	All data present, actuarial not required	D. Kruger

SOUTH CAROLINA WIND AND HAIL UNDERWRITING ASSOCIATION
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June 22, 2009

Kristina Carefelle
Associate Auditor
South Carolina Legislative Audit Council
1331 Elmwood Avenue
Suite 315
Columbia, C 29201

Review of the Department of Insurance
South Carolina Wind Pool Section

Dear Ms. Carefelle:

Let me begin by thanking you and the other members of the Legislative Audit Council staff for the professional courtesies extended to me and to the Association during this process.

At this time, please allow me to respond to the recommendations which appear in the captioned report.

This Association does maintain "an open and competitive process" for the placement of reinsurance. This process includes both the selection of reinsurance brokers and reinsurance companies. This process was used during First Quarter 2008 when the Association undertook a Request for Proposal process to select a reinsurance broker.

As you noted, this process is not included in the Plan of Operation. We apologize for this oversight and are beginning the process of taking the corrective action to formally amend the Plan of Operation and seek its approval from the South Carolina Department of Insurance.

During this process, we will be reviewing our procedures for selection of reinsurance brokers. We will incorporate your suggestions to document the weighting of each of the evaluation factors. While price (commission / fees) is a factor in our current process, we will better document its role in the decision-making process.

Again, thank you for your assistance and recommendations.

Sincerely,

J Smith H

J. Smith Harrison, Jr., CPCU
Executive Director

JSH/sb

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